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Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, DC 20006-2803

comments@pcaobus.org

Re: Rulemaking Docket Matter No. 030

PCAOB Release No. 2010-0001: Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards

Gentlemen:

I appreciate the opportunity to comment on the proposed auditing standard. By way of background, I have advised boards of directors and audit committees on accounting, audit and SEC matters, have served on the audit committee of a large not-for-profit entity and on the board of directors and the chair of the audit committee of a New York Stock Exchange company. My views on this proposal are informed by my experiences as an audit committee member and as an accountant and auditor in public practice.

My comments are organized as follows –

- A. General Comments
- B. Responses to Questions asked in the Overview
- C. Suggestions for the improvement of the Proposal
- D. Appendix A – Definitions
- E. Appendix C – Matters Communicated in the Audit Engagement Letter

**A. General Comments**

The Auditor and the Audit. The Introduction to the proposal says, “Effective two-way communications between the auditor and the audit committee on such [accounting and disclosure] matters might ... benefit the auditor in performing the audit.” I agree that the required communications “might benefit the auditor in performing the audit;” however, the proposal does not make the case for the benefit to the audit by showing how the proposals communications to the audit committee directly achieve the auditor’s responsibilities. This responsibility is clearly expressed in the Engagement Letter in Appendix C as –

Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.<sup>1</sup>

The proposal does not offer or reference any research or findings that show the communications in the proposal (which are principally one way to the audit committee) do in fact directly achieve the objective of the audit. I note that the AICPA's AU 380 ("The Auditor's Communication With Those Charged With Governance") does not make any such claim when saying –

While communication with those charged with governance may assist the auditor in planning the scope and timing of the audit, it does not change the auditor's sole responsibility to determine the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.<sup>2</sup>

The Audit Committee. Audit committees ordinarily welcome any and all information from their auditors; nevertheless, audit committees are overloaded with required duties including the oversight of the internal audit function, compliance with regulatory and legal requirements, the integrity of the financial statements, whistleblower procedures, etc., and the new communications included in this proposal, (which go beyond those in extant AU 380, "Communication With Audit Committees") do not fill any long pent-up needs of audit committees. In fact, if any of the communications included in this proposal are needed by the audit committee, it has been my experience that the committee members will not be shy to ask for it.

Certain of the new communications appear to best fit into what may be considered "best practices," and may very well be useful to the audit committee, but they should not be unconditionally required or presumptively mandatorily required of the auditor.

## B. Responses to Questions asked in the Overview

Q. 1. Are the objectives of the auditor in the proposed appropriate? If not, why?

See comments under paragraph 3 of the proposal in Section C below.

Should other matters be included in the objectives?

Yes.

Q. 2. Are the objectives adequately articulated?

Yes, the summary of the proposal encapsulated in the objectives would be sufficiently stated after the clarifications specified in the comments to paragraph 3 of the proposal.

Should the articulation of the objectives focus on the outcome that should be achieved by performing the required procedures?

As now written, the objectives in paragraph 3 do not focus on outcomes, except for the two-way communications under paragraph 3(d). An articulation of the expected the outcomes would make the standard more "principles based" (less rules based) and encourage (and allow) auditors to receive meaningful communications and corroborating information by using professional judgment and procedures that are not called-for in the proposal.

Q. 3. Is it appropriate for the proposed standard to require that an engagement letter be prepared annually? If not, why?

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<sup>1</sup> AU 110.02 and AU 316.01.

<sup>2</sup> AU 380.33.

A tailored engagement letter should be required annually that (among other things) provides for discrete audit services. Among many other benefits, this annual letter would reduce the possibility that the “continuous representation” doctrine will permit otherwise untimely malpractice claims to proceed against auditors.

Q. 4. Are there other matters that would enhance investor protection that should be added to an engagement letter?

Yes.

If so, what other matters should be included in an engagement letter?

I believe the following matters should aid the audit committee in fulfilling its functions and further protect shareholder interests.

1. The engagement letter should be addressed to the audit committee or its chair and those in management who will sign the letter. It should be signed and delivered to the auditor before any substantial audit procedures are undertaken.
2. In that the audit committee has oversight over the appointment and compensation of the auditor, and that the proxy rules require disclosure of the audit fees,<sup>3</sup> these fees (that is, all audit fees, and (if not covered by a separate engagement letter) all audit-related fees), should be included in the engagement letter.
3. Since services and fees must be pre-approved by the audit committee, engagement letters for subsidiaries, and services provided to employee benefit plans and statutory audits, should be addressed to the audit committee.
4. The auditor must commit to and is responsible for providing timely services; therefore “timing of the audit”<sup>4</sup> should be included in the letter. Timing of the audit is discussed in AU 311, “Planning and Supervision,” and securing timely services from the auditor is another matter that is vitally important to the audit committee and shareholders.
5. Section 10A(a) of the 1934 Act<sup>5</sup> requires audit procedures that are designed to detect illegal acts, identify material related party transactions and evaluate whether or not the registrant is a going concern. These required Section 10A procedures should be included as part of the auditor’s responsibilities in the engagement letter.
6. The engagement letter in Appendix C only sets forth the responsibilities of the auditor and management; however, since these letters are addressed to the audit committee and signed by its chair, it is important that the responsibilities of the audit committee also be included in the letter. I suggest that certain of the language in 1934 Act Rule 10A-3, “Listing

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<sup>3</sup> 1934 Act, Item 9(e) of Schedule 14A.

<sup>4</sup> As used in paragraph 9 of the proposal.

<sup>5</sup> Section 10A(a) In General. - Each audit required pursuant to this title of the financial statements of an issuer by an independent public accountant shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission-

1. procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
2. procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and
3. an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

Standards Relating to Audit Committees,”<sup>6</sup> and Regulation S-K, Item 306, “Audit Committee Report,” be added to the letter in Appendix C.

7. Paragraph 10 of the proposal contains a number of other communications that are appropriate for inclusion in the engagement letter. For example, the use of other firms to perform audit procedures, and the confirmation of the “principal auditor” status in light of the use of those other firms.

Q. 5. Is the proposed requirement to inquire of the audit committee appropriate?

Yes and no.

Yes, the requirement regarding “complaints or concerns raised regarding accounting or auditing matters” (paragraph 8) is an appropriate line of inquiry for the auditor.<sup>7</sup>

No, the proposal requires the auditor to “inquire of the audit committee about whether they are aware of other matters that may be related to the audit ....” This is entirely too broad and unfocused, in essence it asks “Is there anything you can or should tell us that relates to the audit? Is there anything we should know?” The final standard should provide more specific guidance and focus this line of inquiry only on material matters.

As mentioned, while this proposal refers to two-way communications in many places, the proposal, as written, is predominately only a one way communication from the auditor to the audit committee, with the single exception found in paragraph 8 of the proposal.

What other specific inquiries, if any, should the proposed standard include for the auditor to make of the audit committee?

Among other things, the audit committee’s understanding about and views on

- (a) complex and/or unusual transactions,
- (b) material related party transactions,
- (c) nonmonetary transactions,
- (d) specific industry accounting followed for new lines of business, and
- (e) uncertain tax positions.

If not readily apparent, this communication should include an explanation of the business purpose and economic rationale behind the transactions, tax positions, or specific industry

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<sup>6</sup> Rule 10A-3 says:

(2) Responsibilities relating to registered public accounting firms. The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.

<sup>7</sup> Exchange Act Section 10A(m)(4): Complaints. Each audit committee shall establish procedures for--

- A. the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
- B. the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

accounting, whether the nonmonetary exchange has commercial substance, and (if not already documented) whether the audit committee (and the full Board) approved such transactions and accounting.

Q. 6. Are the requirements to provide information on the auditor's audit strategy and timing of the audit appropriate?

No. See below and comments under paragraph 9 of the proposal.

Does the auditor need more guidance related to the requirement to provide information on the auditor's audit strategy?

Yes.

If so, what type of guidance would be helpful?

#### Audit Strategy vs. Scope of the Audit vs. Audit Plan

First, “audit strategy” must be explained. Audit strategy is not a defined term and means different things to different auditors and audit committee members. For example, AU 312.16<sup>8</sup> differentiates “audit strategy” from the conduct and “scope of the audit,” and AU 380.33 appears to distinguish “audit strategy” from “audit plan” and the nature, timing and extent of audit procedures. Further AU 311, “Planning and Supervision,” says that in planning the audit, auditors may consider “Discussing the type, scope, and timing of the audit with management of the entity, the board of directors, or its audit committee.”<sup>9</sup> There is no mention here about “audit strategy.”

1934 Act Rule 10A-3(b)(2) says –

The audit committee ... must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged ... for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.

It is therefore necessary for the audit committee to understand the details of the audit and review with the auditor the plan and scope of the audit, and this request for this information should be initiated by the audit committee. Many audit committees include in their charter a provision to obtain and review the annual audit plan of the auditors, including the scope of the audit activities and to monitor the plan's progress and results throughout the year.

In sum, the term “audit strategy” must be defined so that all auditors will interpret it the same way and be able to differentiate it from “plan” and “scope.” Perhaps all these words are synonymous; if they are then the definition should say so, and if they are not, then the final standard should distinguish them.

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<sup>8</sup> AU 312, “Audit Risk and Materiality in Conducting an Audit,” states:

.16 An assessment of the risk of material misstatement (whether caused by error or fraud) should be made during planning. The auditor's understanding of internal control may heighten or mitigate the auditor's concern about the risk of material misstatement. (Footnote omitted) In considering audit risk, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud. (Footnote omitted) The auditor should consider the effect of these assessments on the overall audit strategy and the expected conduct and scope of the audit. (Emphasis added)

<sup>9</sup> AU 311.04(e).

## Compromise the Audit

The proposal's warning (on page 9) informs auditors that having this discussion about audit strategy is dangerous and may reduce or entirely eliminate the effectiveness of certain audit procedures. I believe that any discussion of planning materiality, tolerable error, the nominal amount for recording audit differences, the extent and detailed scope of tests and procedures are not appropriate discussion topics with the audit committee or management. The final standard should provide some guidance aimed at eliminating any risk of a compromised audit.

Q. 7. Is it sufficiently clear which types of arrangements should be communicated to the audit committee related to the roles, responsibilities, and locations of firms participating in the audit?

Paragraph 10(d) of the proposal (regarding “[t]he roles, responsibilities, and locations of firms participating in the audit ...”) is clear. However, while it may be interesting information to members of the audit committee and supports and justifies a portion of the audit fee, conveyance of this information to the audit committee is unnecessary for the purposes of achieving the objectives of an audit. See additional comments on paragraph 10 of the proposal.

Q. 8. Are the proposed requirements regarding the auditor's communication responsibilities with respect to accounting policies and practices sufficiently clear in the proposed standard (e.g., is the difference between a critical accounting policy and a significant accounting policy or practice adequately described)?

No. Appendix A should define “accounting policies” which APB 22, “Disclosure of Accounting Policies,” defines as –

The accounting policies of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of an entity to be the most appropriate in the circumstances to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles and that, accordingly, have been adopted for preparing financial statements.

The PCAOB's definition should then differentiate these APB 22 “significant accounting policies” disclosed in the financial statements footnotes from “critical accounting policies and procedures,” required by the SEC<sup>10</sup> which must be disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

Q. 9. Is it helpful to include in the proposed standard the audit committee communications required by the SEC relating to accounting matters?

Yes. In that the SEC has oversight and enforcement authority over the PCAOB, and that all rules of the Board are not effective without prior approval of the SEC, the final standard should be wholly integrated with the SEC's requirements. Consequently, the standard should cite the all relevant SEC pronouncements, for example, 1934 Act Section 10A(k),<sup>11</sup> either in Notes, footnotes, or in an appendix to the final standard.

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<sup>10</sup> SEC Release 33-8040; FR 60, “Cautionary Advice Regarding Disclosure About Critical Accounting Policies.”

<sup>11</sup> Rule 10A(k) Reports to Audit Committees. Each registered public accounting firm that performs for any issuer any audit required by this title shall timely report to the audit committee of the issuer--

1. all critical accounting policies and practices to be used;

In addition, there may be certain non-SEC rules that are important to auditor/audit committee communications and relationships such as Sarbanes-Oxley Rule 303, “Improper Influence on Audits,” that should either be included in the final standard, or a reference made to that Rule.

Q. 10. Is the definition of critical accounting estimates appropriate for determining which estimates should be communicated to the audit committee?

While the definition used in Appendix A of “critical accounting estimates” is used in the SEC literature,<sup>12</sup> the terms used “financial condition” and “operating performance” need to be updated and modernized to “financial position” (or “balance sheet”) and “statement of operations” (or “statement of income”).

Further, the proposal does not address why the term “assumptions” used by the SEC (Release 33-8350; FR 72) has been left out of the PCAOB’s definition.

To follow the SEC’s lead, the definition should differentiate between critical accounting estimates (disclosed in MD&A) and accounting policies (disclosed in financial statement footnotes) under FR 72.<sup>13</sup>

Q. 11. Are the communication requirements regarding critical accounting estimates appropriate? If not, how should the proposed standard be modified to provide appropriate information to the audit committee?

See comments under paragraph 12(b) of the proposal.

Q. 12. Should this requirement be expanded to include consultations on accounting or auditing matters with non-accountants, such as consulting firms or law firms?

No. Management’s discussions with a “reporting accountant”<sup>14</sup> should be discussed with the audit committee (paragraph 15 of the proposal). All other consultations by management

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2. all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and
  3. other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

<sup>12</sup> The definition in SEC Release 33-8350; FR 72, “Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations,” is –

When preparing disclosure under the current requirements, companies should consider whether they have made accounting estimates or assumptions where: the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates and on financial condition or operating performance is material. If so, companies should provide disclosure about those critical accounting estimates or assumptions in their MD&A (emphasis added).

<sup>13</sup> Such [critical accounting estimates] disclosure should supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements. The disclosure should provide greater insight into the quality and variability of reported financial information. The discussion in MD&A should present a company’s analysis of the uncertainties involved in applying a principle at a given time, or the variability that is reasonably likely to result from its application over time.

on accounting or auditing matters with non-accountants should not be a required communication by the auditors to the audit committee. The auditor's judgment should dictate whether or not to communicate this category of information to the audit committee.

Q. 13. Is the communication requirement on going concern clear? If not, how could the requirement be clarified?

No. The Note to paragraph 16 of the proposal is not clear as to what must be communicated (a) "when the auditor has concluded that implementation of management's plan mitigate the effects" of a going concern, and (b) when management's plan do not mitigate the effects of a going concern discussed on page 14 (the sentence before question 13).

If there is any distinction in disclosure (other than whether or not management's plans do or do not mitigate the going concern), those disclosures should be differentiated. Further, the Note should be integrated into the final standard.

Along with this communication, any contemplated modification to the standard report should be timely (interpreted by me to mean immediately) communicated to the audit committee.

Q. 14. Are the requirements appropriate regarding the communications for uncorrected misstatements?

No. While the communication of uncorrected misstatements is appropriate, I do not agree with the requirement to "communicate the basis for the auditor's determination that the uncorrected misstatements were immaterial, including the qualitative factors considered," when that communication may compromise the audit by revealing, for example, the auditor's planning materiality, tolerable error and the amount used for recording audit differences, among other auditor considerations.

Q. 15. Should all corrected misstatements including those detected by management be communicated to the audit committee?

Yes, all material corrected misstatements detected by the auditor should be communicated to the audit committee.

However, I see no benefit to the audit committee, or to the audit process, of having all corrected misstatements detected by management communicated to the audit committee. This should be furnished only if the audit committee asks for it, or those corrected misstatements were not detected on a timely basis and are therefore considered by the auditor a significant deficiency, material weakness<sup>15</sup> or the subject of a management letter.

Q. 16. Like the existing standard, the proposed standard would allow the auditor to communicate many matters orally or in writing. Should the standard require that all or certain matters be communicated to the audit committee in writing? If only certain matters should be communicated to the audit committee in writing, what are those matters?

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<sup>14</sup> Reporting accountant is defined as follows (AU 625, "Reports on the Application of Accounting Principles," paragraph 2):

For purposes of this section, reporting accountant refers to an accountant in public practice who prepares a written report or provides oral advice on the application of accounting principles to specified transactions involving facts and circumstances of a specific entity, or the type of opinion that may be rendered on a specific entity's financial statements (footnotes omitted).

<sup>15</sup> See AU 325, "Communications About Control Deficiencies in an Audit of Financial Statements."



In my experience, audit committees usually want all important communications to be written; whereas auditors would likely prefer using their professional judgment to determine those orally communicated and those that should be written. The final proposal should encourage the written documentation of all significant communications.

If at a meeting with the audit committee there are oral communications concerning non-trivial matters, then that meeting with the audit committee should be documented for the working papers (e.g., the subject matter, who attended, the date and time, the location and what was concluded).

The Note to paragraph 23 requires the auditor to include in the audit documentation a copy or summary of management's communications that are specified in paragraph 12 of the proposal that had been given to the audit committee. As commented on under paragraph 12 of the proposal this accumulation of documents or summarization of communications throughout the year is unfeasible.

Q. 17. Are the requirements in the proposed standard on the timing of the auditor's communications appropriate?

Yes, however the proposal does not consider the auditor's review of interim financial information and all the communications with the audit committee that stem from those reviews throughout the year. It is difficult to envision just how the auditor is to evaluate the audit committee communications without consideration of all these "during the year" communications.

Should only certain matters be communicated annually?

No. Matters that should only be communicated annually should be left to the professional judgment of the auditor. No matter should be fixed as to when it should be communicated.

If so, which ones?

Not applicable.

Q. 18. Does the requirement to evaluate the adequacy of the communication process promote effective two-way communications?

If you grade a process, that act of evaluation does not make the two-way process better.

Grading your "employer" will be an interesting challenge to auditors, especially if auditors must document their views about the quantity and quality of the discussions throughout the year, and document their views regarding the members of the audit committee. Does the auditor evaluate the audit committee as knowledgeable and well informed, or the opposite? How does the auditor do this? Do they give the audit committee a grade, for example, A to F? Pass or Fail? How will auditors evaluate their own role in the communication process?

Is more information on this requirement needed?

Yes. Questions that need to be answered –

1. What does the auditor need to know and do to perform this subjective evaluation of the adequacy of effective two-way communications?
2. What (if any) training or ability should the auditor have in order to uniformly evaluate the adequacy of all the communications made during the year?
3. How do the communications meet the objective of the audit?
4. See other comments on paragraph 26 of the proposal.

Q. 19. Are these other communication requirements appropriate and sufficiently clear?

Yes.

What other communication requirements should the proposed standard include, if any?

Not applicable.

Q. 20. Are the matters included as significant difficulties in paragraph 21 of the proposed standard appropriate?

Yes.

What other matters should be included as significant difficulties?

Not applicable.

Q. 21. Are any of the requirements included in the proposed standard inappropriate for auditors to communicate to audit committees based on the size or industry of the company under audit?

The final standard should apply to all SEC registrants without regard to size or industry.

Q. 22. Is the information included in Appendices A - C to the proposed standard sufficiently clear? The appendices include other matters, e.g., should other items be included in an audit engagement letter?

See my specific comments on these appendices and the engagement letter.

### C. Suggestions for the improvement of the Proposal

Paragraph 3. The objectives of the auditor.

The Auditor and the Audit. I recommend the final standard provide some exposition of the direct link between the communications to the audit committee and the ultimate objective of an audit, i.e., “the financial statements are free of material misstatement.”

The primary objective of this proposal should be to meet and satisfy that ultimate objective.

The Audit Committee. Since the passage of Sarbanes-Oxley, and the release of updated SEC and exchange rules, I believe that many audit committees have enhanced their performance to the point where the committee’s agendas are crammed with required activities and many committees are overburdened.

I have not found any research or studies that show audit committee members have a direct interest in many of the communications by the auditor set forth in this proposal.

The communications in this proposal should not be mandatory unless it can be empirically shown that (1) these communications achieve the objective of the audit, (2) audit committees are not effective in fulfilling their oversight responsibilities, and (3) that the communications cataloged in the proposal are shown to be necessary to meet the audit committees oversight obligations.

Paragraph 3(a). Communicating to the audit committee the responsibilities of the auditor ....

The objective should more closely follow the requirements of Appendix C and I suggest the paragraph be worded as follows –

Communicating to the audit committee the objectives of the audit, the auditor’s, management’s and the audit committee’s responsibilities in relation to the audit, and establishing a mutual understanding of the terms of the audit engagement by means of an audit engagement letter;

Paragraph 3(b). Communicating to the audit committee an overview of the audit strategy ....

See the response to Question 6 regarding “audit strategy.”

Paragraph 3(d). Evaluating the adequacy of the two-way communications between the auditor ....

The standard should state (1) the reasons for the evaluation and (2) what particular audit objective is achieved through the adequacy of the communications.

As mentioned in response to question 5, while this proposal refers to two-way communications in many places, the proposal is predominately only a one way communication from the auditor to the audit committee, with the single exception found in paragraph 8 of the proposal. There is a discernible disconnect between all the one-way communications and this objective to evaluate the two-way communications.

The standard does not plainly link the evaluation to the objectives of the audit, that is, if the evaluation, for example, is sub-par, are the audited financial statements materially misstated? How would the opinion be qualified? Is there a scope limitation? Is there an explanatory paragraph needed (and what would it say)?

Paragraph 5. The auditor should establish a mutual understanding of the terms ....

This sentence should include the term “engagement letter,” and suggest it read as “The auditor should establish a mutual understanding of the terms of the audit engagement with the audit committee ~~in connection with the audit~~ by means of an audit engagement letter.”

As mentioned above, since the letter is ordinarily addressed to the audit committee (and others) and signed by the audit committee chair (and others), the engagement letter should have a section that sets out the responsibilities of the audit committee.

Paragraph 6. The auditor should record the understanding of the terms of the audit engagement ....

As mentioned in response to question 4, the engagement letter should be signed by all the appropriate parties and delivered to the auditor before any substantive audit procedures are undertaken. This recommendation should be reconciled with the Regulation S-X definition of when a professional engagement period begins.<sup>16</sup>

The Note to paragraph 6 should be deleted and a footnote added to paragraph 5, after the mention of the engagement letter, referencing Appendix C.

Paragraph 7. If the auditor cannot establish a mutual understanding of the terms ....

Notwithstanding its use in AU 310, “Appointment of the Independent Auditor,” the difference between “accept” and “perform” needs to be explained. Consider the following suggested change, “If the auditor cannot establish a mutual understanding of the terms of the audit engagement with the audit committee, or the engagement letter is not appropriately signed, the auditor should decline to ~~accept or~~ perform the engagement.”

Paragraph 8. The auditor should inquire of the audit committee whether ....

See the comments under question 5. A more focused discussion should begin with those outlined in paragraph 53(b) of proposed Auditing Standard “Identifying and Assessing

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<sup>16</sup> Under Regulation S-X, Rule 2-01(f)(5)(ii)(A) – The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client’s financial statements) or begins audit, review, or attest procedures, whichever is earlier; ....

Risks of Material Misstatement.”<sup>17</sup> Assuming that this proposed Auditing Standard is adopted as exposed, then paragraph 8 would be redundant and should be deleted.

Paragraph 9. The auditor should communicate to the audit committee an overview ...

See response to question 6 regarding the communication to the audit committee of an overview of the audit strategy.

Page 8 of the Overview of the proposal says –

Early communication of these matters may enable the audit committee to understand the auditor's views regarding risk and to provide insights regarding additional risks not identified by the auditor in order for the auditor to incorporate them into the audit strategy.

This communication would only provide additional insight if the auditor asks the audit committee for their understanding of the audit risks; however, the proposal does not require (or mention the need for) the auditor to inquire of the audit committee about significant risks.

It is not clear whether the term “audit strategy” subsumes “significant risks identified during risk assessment procedures,” or if significant risks are another subject to be communicated. If just another subject, then the word “including” should be deleted.

As to “timing of the audit,” include with paragraph 9 the discussion from paragraph K (page 16) –

For example, some communications, such as information regarding the audit strategy and the significant risks, should be made as early as possible and other matters, such as changes to the auditor's significant risks initially identified should be communicated in a timely manner.

Regarding the discussion of significant risk, in order not to compromise the audit, I believe the auditor should just outline the risks, and not discuss what additional procedures will be undertaken to meet those risks.

Note: The overview is intended to provide information about the audit, but not specific details ...

Here the question is when does the auditor “cross the line” from the general to the specific? From a benign communication to having compromised the audit? There is no simple solution and as mentioned above I believe that it would be helpful to define “audit strategy” in such a way that it would be interpreted the same way by all auditors and audit committees.

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<sup>17</sup> This paragraph discusses –

Inquiries of the audit committee, or equivalent, or its chair regarding:

- (1) The audit committee's views about the risks of fraud;
- (2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;
- (3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program) and, if so, the audit committee's responses to such tips and complaints; and
- (4) How the audit committee exercises oversight of the company's assessment of the risks of fraud and the establishment of mitigating controls.

Paragraph 10. The auditor also should communicate the following matters ....

Delete the word “also.”

Paragraph 10(a). The auditor's determination of whether persons with specialized skill ....

This may be worthy questions for the audit committee to ask the auditor, but it not a necessary procedure needed to perform the audit.

Paragraph 10(b). The auditor's consideration of, and planned use of, the company's ....

It is unclear why this communication of the “consideration of and planned use of internal auditors during audit” is needed by the auditor to achieve the objective of the audit (i.e., whether the financial statements are free of material misstatement).

Paragraph 10c. The auditor's consideration of the extent to which the auditor plans to use ....

The difference (if any) between paragraph 10(b) and 10(c) regarding the consideration and use of internal auditors should be explained.

Paragraph 10d. The roles, responsibilities, and locations of firms participating in the audit ....

Use of other firms is assumed to mean auditing firms, if so, I suggest adding “audit” (or “registered public accounting”) before the word firms.

Paragraph 10e. The basis for the auditor's determination that he or she can serve as principal auditor.

In drafting the engagement letter, the auditor should determine that (based on the then facts) it will be the principal auditor. That assessment should be included in the engagement letter. It is not clear why the basis for this conclusion is a necessary separate communication to the audit committee assuming the auditor follows the guidance in AU 311 and AU 543 in his or her audit.

Paragraph 11. The auditor should communicate to the audit committee significant changes ....

This paragraph should be combined with, or added to paragraph 9 and should plainly say that this means any significant decrease or increase in the risks initially identified.

This undertaking by the auditor, to timely communicate significant changes to the planned audit strategy or the significant risks initially identified (due to the results of audit procedures or in response to external factors or changes in the economic environment), should be incorporated into the engagement letter.

Paragraph 12(a)(ii). The anticipated application by management of accounting or regulatory ....

The SEC requires disclosure of newly issued pronouncements which will have a material impact on financial statements; consequently, there is no need for this requirement since there is already sufficient disclosure in MD&A and the financial statement footnotes, all of which audit committees are obliged to review.

This paragraph should reference SAB Topic II-M, SAB 74, as it was referenced on page 10.

Paragraph 12(a)(iii). The methods used by management to account for significant ....

The final standard should clarify why it believes that the audit committee, the board of directors, management including the CFO do not already communicate this and other information in this proposal, and that the auditor then has the responsibility to remedy these internal communication breakdowns.

There is no evidence that the audit committee in its oversight of financial reporting does not have ample access to management, the CFO, the internal auditors, and others, and

needs this information about (1) “methods” to be communicated to it by the auditors, and (2) that the auditor must tell the audit committee about accounting for significant and unusual transactions.

If there is empirical evidence that a significant number of audit committees are ignorant of all this information, then there is a bigger problem and this proposal will not and cannot cure it.

Paragraph 12(a)(iv). The effect of significant accounting policies in controversial ....

In the caption before paragraph 12 (Accounting Policies ...) and paragraphs 12 and 12(a) the word “significant” should be inserted (thus “Significant Accounting Policies ...”). This will then agree the requirements in this paragraph with those in paragraph 13(a).

Paragraph 12(b)(i). A description of the process used by management to develop ....

Why is this reporting by the auditor to the audit committee needed? Assembling this information is not within the purview of the auditors and if the audit committee needs this information it can be obtained directly from management, and if necessary, that information can be supplemented by questions posed to the auditor. The internal controls over critical accounting estimates should be communicated by management, not the auditor.

Paragraph 12(b)(ii). Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;

This information is required in MD&A by FR 72 for interim and annual reporting. There is no need for auditors to communicate this to the audit committee since the audit committee is obliged to review all the financial statements and other information included in filings with the SEC

Paragraph 12(b)(iii). Any significant changes to assumptions or processes made by management ....

Again, this is required by FR 72, and there is no need for auditors to communicate this to the audit committee.

What is the significance of “... in the year under audit ....”? Are not all of these communications in this proposal for the year under audit?

Paragraph 12(b)(iv). When critical accounting estimates involve a range of possible outcomes ....

If the audit committee (or management) deems it necessary to build such pro forma financial statements with various plus and minus outcome ranges across perhaps a dozen critical accounting estimates they certainly are already free to do so. This is not an audit procedure required of auditors<sup>18</sup> and auditors should not be asked to prepare these extraordinarily elaborate pro forma financial statements.

Note: As part of its communications to the audit committee, management may communicate ....

Note 12 of the Proposal asks for exception reporting and requires that the auditor gain knowledge of every communication by management to the audit committee throughout the year, evaluate those communications, and then report to the audit committee whether or not the matters were adequately described or not communicated. Such communications are not necessary to achieve the objectives of the audit. Auditors should not be in the business

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<sup>18</sup> See AU 342, “Auditing Accounting Estimates.”

of fixing the communications between management and the auditor committee; this requirement is unworkable and should be removed.

Paragraph 13. The auditor should communicate to the audit committee the following matters:

I could not determine from this release why all the guidance in extant AU 380.11<sup>19</sup> was not included in this proposal. It should be.

Paragraph 13(b)(i). An evaluation of management's disclosures related to the critical accounting ....

The footnote (referring to Reg. S-X, Rule 2-07(a)(1)) should also include a reference to 1934 Act Section 10A(k) dealing with critical accounting policies.

Paragraph 13(b)(ii). The reasons certain policies and practices are considered critical ....

This requirement goes beyond the disclosures made by management in MD&A and required by auditors under Section 10A(k).

As written this communication is too terse. Management is primarily responsible for determining whether accounting policies are critical. If the auditor does not agree with management's determination, or believes there are critical accounting policies which management overlooked and management disagrees, then the auditor should communicate this disagreement with the audit committee.

Paragraph 13(b)(iii). How current and anticipated future events generally may affect ....

This requires that anticipated future events must be foreseen by the auditor, then the auditor must understand how such future events would impact the particular registrant and a specific critical accounting policy. This goes beyond the objective of a financial statement audit and is likely well beyond the skill set of many auditors. Again, management determines whether accounting policies are critical, the auditor may or may not agree.

Paragraph 13(c). Critical accounting estimates. Both the auditor's evaluation of the reasonableness ....

Paragraph 13(d). Accounting Estimates. If the auditor determines that potential bias ....

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<sup>19</sup> AU 308.11. In connection with each SEC engagement (reference omitted), the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. Since the primary responsibility for establishing an entity's accounting principles rests with management, the discussion generally would include management as an active participant. The discussion should be open and frank and generally should include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. (Footnote omitted) Examples of items that may have such an impact are the following:

- Selection of new or changes to accounting policies
- Estimates, judgments, and uncertainties
- Unusual transactions
- Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded

Objective criteria have not been developed to aid in the consistent evaluation of the quality of an entity's accounting principles as applied in its financial statements. The discussion should be tailored to the entity's specific circumstances, including accounting applications and practices not explicitly addressed in the accounting literature, for example, those that may be unique to an industry.

Reference should be made to AU 342, “Auditing Accounting Estimates.” Here, in evaluating the reasonableness of an estimate the auditor is instructed to consider bias among many other things.

At issue is whether there is any estimate management makes that is free of bias and determining and reporting on management’s “potential bias” assumes the auditor knows every fact, assumes the auditor is her (or him) self entirely free of any bias, and is therefore a very subjective determination. Notwithstanding these caveats, the auditor should report what appears to be a possible management bias to the audit committee.

The final standard should address the question: After reporting on management’s potential bias, what action or communication should the auditor expect from the audit committee?

Paragraph 13(f). Significant accounting matters for which the auditor has consulted outside ....

The release does not explain why communication with others outside the engagement team should be communicated to the audit committee. What will this communication convey to the audit committee? Does it suggest the auditor’s believe there is some uncertainty or risk associated with the subject of the consultation? There is a matter about which the auditors have little or no knowledge? Something else? Should the audit committee now evaluate the experience, competence and sophistication of the audit team or audit firm if there is such consultation?

In sum, unless the auditor’s are consulting on an accounting position that is contrary to management’s position, such communication to the audit committee is unnecessary.

Paragraph 14. When other information is presented in documents containing audited financial ....

This responsibility should be incorporated into the engagement letter. Under AU 550 this is an auditor – management issue and therefore I suggest that the PCAOB amend AU 550 if communication should also include the board of directors and the audit committee.

Paragraph 15. When the auditor is aware that management consulted with other accountants ....

The PCAOB standards do not include the AICPA’s interpretation of AU 625, “Reports on the Application of Accounting Principles,” thus there is no exception for “advisory accountants.”<sup>20</sup> Consideration should be given to amending AU 625 or revising that standard to more closely align with the AICPA’s recent proposed auditing standard.

Paragraph 16. The auditor should communicate to the audit committee ....

In addition to this going concern issue, auditor’s should consider other communications required under 1934 Act Section 10A, “Audit Requirements,” e.g., the procedures designed to provide reasonable assurance of detecting illegal acts and procedures designed to identify related party transactions.

Paragraph 17. The auditor should provide the audit committee with the schedule of uncorrected ....

This should be clarified and say –

The auditor should provide the audit committee with the schedule of all uncorrected misstatements related to accounts and uncorrected disclosures that ~~was~~ were presented to management.

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<sup>20</sup> AICPA AU 9625.



The final standard should differentiate this requirement from the SEC's requirement regarding "material correcting adjustments",<sup>21</sup> and the SEC's requirement regarding "unadjusted differences."<sup>22</sup> The final standard should also consider defining "uncorrected disclosures." I assume this to mean either financial statement disclosures that are materially misleading, or disclosures that were not made, but should be.

Paragraph 18. The auditor should communicate to the audit committee the basis for the auditor's ....

This appears to require the sharing with the audit committee and management (a) the level(s) of materiality used by the auditor, both individually and in the aggregate, (b) the amount of tolerable misstatement that the auditor is willing to accept, (c) analysis of uncorrected misstatements on trends, (d) the rollover and iron curtain considerations, and (e) various subjective qualitative measures.

I believe this sharing will compromise audits.

Some comments on the second sentence.

1. I cannot determine why this is a necessary communication, unless it is meant to show the value of the audit, or how error prone management is. Clearly, the auditor cannot issue an unqualified opinion on the financial statements if the financial statements are materially misstated.

2. Should auditors communicate undetected misstatements to the audit committee? AU 312.65 says –

If the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, they could still be materially misstated because of further misstatements remaining undetected. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases; consequently, the auditor should also consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

Consideration should be given to including some mention of undetected misstatements in the engagement letter.

3. Also this proposal does not deal with if and how the auditor should communicate rollover and iron curtain effects of uncorrected misstatements assuming the basis for immateriality is shared with the audit committee.

AU 312.53 says –

In aggregating misstatements, the auditor should include the effect on the current period's financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, the auditor should consider the effects of these

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<sup>21</sup> Section 401(a) of the Act requires that each financial report of an issuer that is required to be prepared in accordance with generally accepted accounting principles (GAAP) shall "reflect all material correcting adjustments ... that have been identified by a registered accounting firm...."

In sum, there is a confusion of terms, e.g., uncorrected misstatements, uncorrected disclosures, material correcting adjustments, and unadjusted differences.

<sup>22</sup> Regulation S-X, Rule 2-07(a)(3) and Section 13(i) of the 1934 Act. In sum, there is a confusion of terms, e.g., uncorrected misstatements, uncorrected disclosures, material correcting adjustments, and unadjusted differences.

uncorrected misstatements in determining whether the financial statements are free of material misstatement.

Note: The auditor should communicate that uncorrected misstatements or matters underlying ...

A reference to AU 312.60(n) should be included in the standard.<sup>23</sup>

Paragraph 20. The auditor should communicate to the audit committee disagreements ...

This paragraph should discuss how, or if, this disagreement with management and reported to the audit committee would be reported in Item 9, “Changes in and Disagreements With Accountants on Accounting and Financial Disclosure,” in the circumstances detailed in Regulation S-K, Item 304.

Paragraph 21(d). Unreasonable restrictions imposed on the auditor by management ...

It is assumed that “restriction” means restrictions on the scope of the audit; however, if it is meant to convey another meaning the paragraph should be expanded.

Paragraph 22. The auditor should communicate to the audit committee other matters arising ...

This objective of this paragraph is that the “auditor ... communicate to the audit committee other matters arising from the audit that are significant to the oversight of the financial reporting process ...” Because responsibilities of a board and the audit committee are governed by state law and are limited by a litigated series of principles, auditors should not be asked to interpret or fulfill this “oversight” responsibility.

This paragraph might be better stated as “... that ~~are~~ may be ~~significant~~ relevant to the oversight of the financial reporting process.” As it now reads, the sentence assumes that auditor’s are knowledgeable regarding the rules, regulations, laws and duties governing the audit committee’s oversight of the financial reporting process.

Paragraph 23. The auditor should communicate to the audit committee the matters in this standard ...

Note: If management communicated matters identified in paragraph 12, the auditor should ...

For the reasons stated in paragraph 12 of the proposal, this inclusion of this documentation may be unworkable, and therefore summaries and copies should not necessarily be collected and included in the working papers.

Footnote 25: See AU sec. 532, Restricting the Use of an Auditor's Report, which applies to ...

The final standard should explain why AU 532 is referenced. The AICPA’s recent revision of AU 380 states, in paragraph 17 –

**Restricted Use:** When the auditor communicates matters in accordance with this SAS in writing, the communication is considered a by-product report (footnote to AU 532.07). Accordingly, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management, and is not intended to be, and should not be, used by anyone other than these specified parties.

Paragraph 24. Audit committee communications should occur in a timely manner ...

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<sup>23</sup> Under AU 312.60(n), uncorrected misstatements impact on future periods means: “The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.”

Saying that communications should be “timely” is entirely too general and is therefore meaningless; however, without the final standard containing a lengthy and detailed exposition regarding timing I cannot think of or suggest a “fix.”

Note: Communications with the audit committee chair may be appropriate if done in order to ...

This assumes that the chair does not or would not communicate with the balance of the audit committee. This follow up with the entire committee places an unwarranted and unnecessary burden on the auditor.

Paragraph 25. All communications required by this standard should be made annually to the audit ...

It is not clear how this annual requirement fits into the one in paragraph 24 “occur in a timely manner.” Regulation S-X, Rule 2-07 talks to the filing of the audit report, while AS 3, “Audit Documentation,” references the report release date, and AU 530 mentions the auditor’s report date. Notwithstanding all these different dates, all the communications should be made at least annually before the date of the auditor’s report.

Paragraph 26. Prior to the issuance of the auditor's report, the auditor should evaluate ...

Guidance regarding this evaluation should be included in the final standard. For example, this evaluation can only be performed at the most senior level of the engagement team, and only by those with direct “hands on” involvement with the audit and who were in direct communication with the audit committee for a substantial number of meetings during the course of the year.

The key here is who on the audit team makes this determination? If more than one person interacts with the committee during the year, should this evaluation be the subject of a “brainstorming” session?

If the auditor is going to assess the audit committee, then the evaluation must take into consideration its impact on the risk of material misstatement and the ability to obtain sufficient audit evidence, and be made no later than the date of the auditor’s report. In order to fulfill the proposed requirement in paragraph 27 the evaluation cannot be made during the period between the date of the auditor’s report and the date of the issuance of the report

Paragraph 26(a). The appropriateness and timeliness of actions taken by the audit committee ...

This requirement should be expanded to discuss the nature and type of matters raised by the auditor that would require a reaction by the audit committee.

Paragraph 26(b). The openness of the audit committee in its communications with the auditor;

Similar to the evaluation required in paragraph 26(a), this determination of “openness” may be entirely too subjective. How does the auditor determine if every card is face up?

Paragraph 26(c). The willingness and capacity of the audit committee to meet with the auditor ...

Willingness and capacity are two separate determinations. Executive sessions are ordinarily scheduled by the audit committee for every committee meeting, and, for example, the NYSE Rules require such meetings.<sup>24</sup>

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<sup>24</sup> The New York Stock Exchange Rules (303A.07) already require audit committees to meet with the auditors:

(E) “... meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors ....”

Paragraph 26(d). The extent to which the audit committee probes issues raised by the auditor.

This evaluation is similar to that in paragraph 26(a), and this paragraph should be combined with 26(a). If there is a meaningful difference, the final standard should differentiate the two paragraphs.

Note: The auditor should read the minutes, if any, relating to audit committee ....

The final proposal should require that the auditor also read and be familiar with the audit committee's charter.

Paragraph 27. If the auditor determines that the two-way communications have not been adequate ....

Under paragraph 26, the evaluation must be made before the report is issued, but if this is after the report is dated, is it not too late?

This paragraph should be expanded to say just what the "appropriate action" should be. Does it mean those actions outlined in paragraph 28?

#### D. Appendix A – Definitions

##### A2. Audit committee

This definition should be referenced to Section 3(a)(58) of the 1934 Act.

##### A3. Critical accounting estimate

This definition should be referenced to SEC Financial Reporting Release No. 72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations."

##### A4. Critical accounting policies and practices

This definition should be referenced to SEC Financial Release No. 60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies."

To avoid confusion between "critical accounting policies" and "accounting policies." this Appendix should define the latter term as found in APB 22 quoted in response to question 8 above.

In addition to the above comments, the term "audit strategy" should be defined, see response to question 6 above.

The term "uncorrected disclosures" should be defined, see comments on paragraph 18 of the proposal.

#### E. Appendix C – Matters Communicated in the Audit Engagement Letter

##### Paragraph C(1)(b)(1)

###### b. Audit of financial statements:

1. The reliance on other auditor's (and the extent of such reliance) should be included in the engagement letter, along with the declaration that the auditor signing the letter is the "principal auditor."
2. Paragraph 14 of the proposal requires the auditor communicate to the audit committee the auditor's responsibilities when other information is presented in documents containing

audited financial statements. This audit responsibility regarding the accuracy of other information should be integrated into the engagement letter.

3. Under the SEC's rules on auditor independence, the audit committee is required to pre-approve audit and non-audit services for the issuer and all of its consolidated subsidiaries, whether those subsidiaries are separate issuers or not. This requirement should be integrated into the engagement letter.

Paragraph C(1)(b)(2).

b. Audit of financial statements:

The requirements contained in the 1934 Act Section 10A belongs in the engagement letter, see response to question 4.

Paragraph C(1)(c).

5. At the conclusion of the engagement, management will provide the auditor with a letter ....

The proposal does not contain a requirement that the representation letter be communicated to the audit committee. The engagement letter should specifically require that the signed management representation letter will be provided to the audit committee on the report date. A best practice would have the auditors give the audit committee a draft of the letter before it is signed by management.

6. Management is responsible for adjusting the financial statements to correct material ....

I suggest adding the underlined to this paragraph "... are immaterial, both individually and in the aggregate (qualitatively and quantitatively), to the financial statements taken as a whole ...."

For other matters that should be included in the engagement letter, see the response to question 4 and comments under paragraphs 11 and 18 of the proposal.